

Office of Chief Counsel
Internal Revenue Service

memorandum

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[REDACTED]

date: APR 02 2002

to: [REDACTED]
LMSB Revenue Agent
Internal Revenue Service
[REDACTED]

from: Associate Area Counsel (LMSB), [REDACTED] CC:LM:CTM: [REDACTED]

subject: [REDACTED]
Proper Treatment of Proceeds from Condemnation

*This memorandum responds to your request for assistance dated February 13, 2002.
This memorandum should not be cited as precedent*

ISSUES

1. What is the proper treatment of proceeds obtained from the condemnation of certain real property interests?
2. What is the proper treatment of the legal fees associated with the court actions involving the negotiation of the condemnation and restitution?

CONCLUSIONS

1. Most likely, all of the proceeds are properly excluded from income pursuant to I.R.C. § 1033. The ownership and receipt of proceeds for the "[REDACTED]" needs to be confirmed before the proper treatment of the proceeds can be confirmed.
2. The legal fees should be capitalized and added to basis in the replacement property.

FACTS

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

On [REDACTED], the Port Commission of the Port of [REDACTED] (the Port) filed a petition in court seeking condemnation by eminent domain of three parcels of real property located on [REDACTED]. These three parcels are known as "[REDACTED]", "[REDACTED]", and "[REDACTED]"

[REDACTED] ([REDACTED]) uses the parcels to [REDACTED]. On [REDACTED], the Port entered into a Settlement Agreement with [REDACTED], [REDACTED], [REDACTED] and [REDACTED], [REDACTED] and [REDACTED]. According to the agreement, at the time the Settlement Agreement was executed, the owner of the "[REDACTED]" and "[REDACTED]" was [REDACTED]. On [REDACTED], the [REDACTED] and [REDACTED] had been conveyed from [REDACTED] to [REDACTED]. [REDACTED] owns a majority of [REDACTED]. The minority is owned by [REDACTED] and [REDACTED]. After ownership was transferred to [REDACTED], [REDACTED] leased the properties from it pursuant to an oral lease.

Also according to the Settlement Agreement, on [REDACTED] [REDACTED] (fka [REDACTED]) owned the "[REDACTED]" [REDACTED] leased the "[REDACTED]" to [REDACTED] under an oral lease. [REDACTED] conducted its business using all three parcels.

The court entered the order granting eminent domain to the Port on [REDACTED]. A dispute ensued as to the proper amount of compensation for the interests in the properties. The parties also disputed the amount of relocation reimbursements. On [REDACTED] the parties entered into the Settlement Agreement scheduling the relocation and setting forth the amount the Port would pay for the interests in the three properties. The amount paid included compensation for certain trade fixtures and [REDACTED] equipment located on the three properties.

According to the Settlement Agreement, for the "[REDACTED]" and "[REDACTED]", [REDACTED], [REDACTED] and [REDACTED] and [REDACTED] were to receive \$ [REDACTED]. For the [REDACTED], [REDACTED], [REDACTED], [REDACTED] and [REDACTED], [REDACTED] and [REDACTED] were to receive \$ [REDACTED].

[REDACTED] received the proceeds from the sale of the properties and invested the proceeds

¹ This is contrary to your written description which states that all three properties were combined into [REDACTED]. The correct facts should be determined.

in the replacement property.² The purchase of replacement property took place on or before [REDACTED]. It is located at [REDACTED] ([REDACTED]).

[REDACTED] also entered into an agreement dated [REDACTED] with the Port for the reimbursement of relocation costs. Reimbursed relocation costs included salaries for individuals planning and executing the move, costs for moving personal property, insurance, licenses, professional services required for planning and executing the relocation including legal fees, costs of new stationary, signs etc., costs of replacement for items not moved from original site ([REDACTED] and other fixtures), and costs of professional services used in connection with the purchase of replacement site. The total relocation cost reimbursement was approximately \$ [REDACTED]. It is not clear which of the [REDACTED] entities received the relocation proceeds or which of the [REDACTED] entities incurred and paid the expenses associated with the relocation.

The entire proceeds from the condemnation and relocation cost reimbursement were used to purchase and improve the [REDACTED] and to relocate [REDACTED]'s business. The new site is used for the same business of [REDACTED] as took place at the [REDACTED] properties. Various upgrades were made to the new site as compared to the old sites. In particular, [REDACTED] replaced the equipment which was not moved from the old site, with new possibly upgraded equipment. Similarly, the buildings on the [REDACTED] were new. Also improvements had to be made to the site to protect the area from contamination.

DISCUSSION

Where property is converted into cash through a condemnation award, the owner can elect to defer gain if the property involuntarily converted is replaced within the allotted replacement period. I.R.C. § 1033(a)(2). The period within which the property must be replaced begins at the earliest date of threat of condemnation and ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized. I.R.C. § 1033(a)(2)(B). The proceeds from the condemnation must be used to purchase qualifying property. I.R.C. § 1033(a)(1). Gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the qualifying replacement property. I.R.C. § 1033(a)(2).

[REDACTED] appears to meet all the requirements for deferral of gain pursuant to I.R.C. § 1033. First, its property on [REDACTED] was subject to imminent domain proceedings, which is a condemnation. Second, it meets the time constraints. Although the specific dates are somewhat

² Because the Settlement Agreement is inconsistent with your description of the facts, it is not clear how the proceeds from the [REDACTED] were used to purchase the [REDACTED] property. [REDACTED]

unclear, it appears the first amounts were paid over to the taxpayer no earlier than [REDACTED] the date of the Settlement Agreement. It appears from the Schedule of Land Improvements that the replacement property at [REDACTED] was acquired no later than [REDACTED]. This is easily with in the required time constraints.

Third, qualifying replacement property was purchased. Taxpayers who involuntarily convert business real estate may qualify for nonrecognition treatment by satisfying either the like-kind or the similar or related in service or use standard. Rev. Rul. 83-70, 1983-1 C.B. 189. The property purchased was used for the same business of [REDACTED] as the condemned property. It appears some improvements were made as new buildings and new fixtures were necessarily acquired. [REDACTED]'s business is not altered and the new buildings and fixtures are used for the same functions as the old equipment. See, e.g., *Davis v. U.S.*, 589 F.2d 446 (9th Cir. 1979) (Court held that proceeds from sea fishery and improved agricultural land sold pursuant to condemnation proceedings invested in industrial property qualified under I.R.C. § 1033(a)). Considering the same use of the property and continuity of the same business, the replacement property qualifies for I.R.C. § 1033 treatment

The transfer of the "[REDACTED]" and "[REDACTED]" to [REDACTED] prior to the condemnation award does not affect the I.R.C. § 1033 treatment. Presumably, the transfers took place pursuant to I.R.C. § 721(a), Contributions to a Partnership. [REDACTED] had control of [REDACTED]. It appears the purpose of the transfer was to facilitate the condemnation and acquisition of new property. If these facts are correct, then the use of [REDACTED] to receive the proceeds and purchase the replacement property does not affect the application of I.R.C. § 1033. Rev. Rul. 84-29, 1984-1 C.B. 181.

The transfer of the "[REDACTED]" is unclear. The Settlement Agreement stated that on [REDACTED], the [REDACTED] was owned by [REDACTED], (b)(5)(AC)
[REDACTED], (b)(5)(AC)
[REDACTED], (b)(5)(AC)

[REDACTED] received proceeds for the "[REDACTED]" and "[REDACTED]" in the amount of \$ [REDACTED]. An additional \$ [REDACTED] was paid for the "[REDACTED]". The cost of the replacement property exceeded \$ [REDACTED].

In addition to the amounts for the property, [REDACTED] or one of its related parties received reimbursement for the cost of relocation and for the value of certain equipment not moved from the original site.³ The relocation cost reimbursement totaled about \$ [REDACTED]. The moving expenses and equipment reimbursement of \$ [REDACTED] also qualifies for I.R.C. § 1033 treatment, to the extent the \$ [REDACTED] does not exceed the amount paid for the replacement property and the expenses associated

³ It is similarly unclear specifically which entity received the reimbursement proceeds and which entity incurred the expenses.

with its acquisition.⁴

In Graphic Press, Inc. v. Commissioner, 523 F.2d 585, 588-89 (9th Cir. 1975),⁵ the Ninth Circuit Court of Appeals held that compensation for moving expenses required to relocate a business pursuant to a condemnation qualifies for I.R.C. § 1033 treatment. Graphic Press hired professional appraisers to value the land and building and to estimate the costs of moving its machinery to a new location and to appraise the business interruption costs involved in the move. These estimates were the basis for settlement. The Tax Court determined that only about a third of the total compensation paid to Graphic Press was compensation for the property. The remainder was for moving expenses. The Tax Court determined this was a "separate loss" not entitled to I.R.C. § 1033 treatment. Id. at 588. The Ninth Circuit Court of Appeals disagreed with the Tax Court. It reasoned that the award is separable into components such as compensation for property and other compensation only if the taxpayer was compensated for losses other than the condemned property. Id. For example, if a portion of the award was to pay for waiver of a statutory right, then that would be compensation for losses other than for the condemned property. Id.

As in Graphic Press, [REDACTED]'s moving expenses arise out of the conversion of the property. The moving expense reimbursement is compensation for the same loss and is entitled to I.R.C. § 1033 treatment. No separate losses are considered in the amount of the settlement.⁶

The cost to acquire the replacement property and the cost of moving exceeded the proceeds received for the real property and reimbursement for moving. To the extent any amount of the proceeds from the condemnation or reimbursement for moving exceeded the amount expended, the amount would be recognized. Further information about the "[REDACTED]" the entity which received the

⁴ This assumes the relocation expenses were paid to [REDACTED] and [REDACTED] incurred the expenses. If this is not correct, further assistance should be sought from Counsel to confirm the treatment of the relocation reimbursement.

⁶ The Settlement Agreement dated [REDACTED] explicitly states that it does not include any amount for liability for the existing contamination of the property. See ¶ 4.3.

reimbursement of relocation costs, the entity which paid the moving expenses is necessary to confirm that the recognition of all of the proceeds is deferred.

Legal Fees

██████████ or one of its related parties also incurred legal fees in conjunction with the condemnation litigation and Settlement Agreement. These costs were not reimbursed by the Port. The treatment of legal fees and other professional fees incurred and paid in conjunction with the negotiations regarding the condemned property depends on the context of the litigation.⁷ If, for example, the condemnation action arose from a county's need for the real estate, and not any specific activity of the taxpayer's business, then the legal fees are incidental to the sale of a capital asset. See Madden v. Commissioner, 514 F.2d 1149, 1151 (9th Cir. 1975). In Madden, legal fees for the condemnation litigation were not expended in litigation arising out of, directly connected with, or proximately resulting from the taxpayer's business of an orchard. Instead the expenses were only tangentially related to the orchard business. Id. at 1150. Such expenses are capital in nature and added to the basis of the asset. Id. at 1151.

In contrast, if the litigation arises out of a municipality's ordinance prohibiting the operation of a taxpayer's business, for example, then the legal fees would be deductible. See Rev. Rul. 78-389, 1978-2 C.B. 126. Such expenses arise out of the taxpayer's business.

For ██████████, the condemnation arises out of the requirement that the use of ██████████ be changed to contain its contamination. Along with the other users of ██████████, ██████████'s business probably created some of the contamination. The condemnation, however, is not focused on ██████████. The condemnation does not prohibit ██████████ from conducting its business in another location. Also, other businesses on ██████████ are required to move. Because the condemnation arose out of the need to contain contamination and is not specific to an activity of ██████████'s business, the legal fees are not currently deductible. In addition, the legal fees arise out of an action regarding the disposition and compensation for a capital asset. The legal fees should be capitalized and added to the basis of the acquired property.

Additional Information Needed:

██████████, (b)(5)(AC)

██████████, (b)(5)(AC)

⁷ These are legal fees that were not reimbursed by the Port. Some legal fees were reimbursed as part of the moving expenses.

[REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

[REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

By [REDACTED]

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